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Dear Sir/Madam

Submission on Proposals – "Response to Submissions – Review of capital standards for general insurers and life insurers" dated 9 December 2011

Thank you for the opportunity to comment on APRA's updated proposals as part of the Life and General Insurance Capital project (LAGIC), including the draft standards released on 9 December 2011.

This submission, which is made on behalf of Challenger Life Company Limited, is set out in Attachment 1 and includes submissions on APRA's "Response to Submissions – Review of capital standards for general insurers and life insurers" (Response Paper) and submissions in respect of the draft standards.

Attachment 2 lists a range of other issues where we believe that further clarification should be made in the final standards.

Challenger has made several prior submissions relating to LAGIC, including submissions dated 4 August 2011 and 3 November 2011. These submissions included important comments which we believe need to be addressed by APRA. While some matters have been addressed in APRA's response and draft standards, there are many areas which we believe still need to be addressed to achieve the required outcomes. For completeness, Attachment 3 summarises the key outstanding issues raised in these submissions. Please refer to these prior submissions for further details on these issues.

If you have any questions, please do not hesitate to contact me.

Yours sincerely

Tony Bofinger
CFO and Appointed Actuary
Challenger Life Company Limited
Attachments:

1. Challenger submissions
2. Further issues requiring clarification
3. Summary of outstanding items from Challenger submissions dated 4 August 2011 and 3 November 2011

Attachment 1: Challenger submissions

1. Summary

We support APRA's efforts to improve the alignment of its capital standards across the industries it regulates and to introduce a simpler, more risk-sensitive approach to capital requirements. We acknowledge that APRA has made a number of improvements over the course of the LAGIC project, most recently in the Response Paper and draft standards. This submission specifically focuses on new issues emerging from the draft standards.

Our submissions, which are detailed in section 2 of this attachment, are as follows:

i. Illiquidity Premium: The illiquidity premium should be determined using a methodology that reacts to movements in markets. That is, it should not be set as a fixed addition to the discount curve.

   The illiquidity premium should be calculated by reference to an index of credit spreads, and the illiquidity premium shocked in response to shocks applied to credit spreads.

   Challenger supports the adoption of the methodology outlined by the Actuaries Institute in its 17 November 2011 submission to APRA regarding illiquidity premiums.

ii. Products to which Illiquidity Premium applies: The word "immediate" should be deleted from both (a) and (b) of section 5 of Attachment D of draft Prudential Standard LPS112. That is, the illiquidity premium should also be added to the risk-free discount rate for deferred annuities.

iii. Look through: We support APRA's intention to reinsert the look through wording.

   The limitations on look through as set out in the current standards should be maintained. Further, the materiality limit should be increased to 2.5% of the value of assets of the statutory fund, consistent with the increase in asset concentration limit for "other assets" under draft Prudential Standard LPS117.

iv. Requirement to revalue standard residential mortgages every 3 years: The requirement to revalue residential properties every 3 years should be removed.

v. Requirement to revalue any secured property if material change in the market: The requirement to revalue residential properties offered for security where the life company becomes aware of a material change in the market value of a property in an area or region should be removed.

vi. Credit derivatives: A life company should be able to enter into credit derivatives without consulting APRA in advance.

vii. Reduction in Capital Base: Payment of dividends or interest payments on Additional Tier 1 or Tier 2 capital in excess of one year's after-tax earnings should not require APRA's written consent.

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viii. Use of Fair Values: APRA should not require a life company to make adjustments to the fair values of its assets and/or liabilities.

ix. Concentration Risk: Concentration limits should be set against individual counterparties, rather than including related parties.

x. Covered bonds: Covered bonds should be treated as bonds when applying the credit spreads stress.

xi. Wholesale Business: Ordinary business where the effective purchasing decision is made by a trustee or company should be considered wholsale business.

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2. Detailed Submissions

2.1 Illiquidity Premium

The draft Prudential Standard LPS112 contemplates the addition of an illiquidity premium to the risk-free discount rate for certain policy types, subject to a minimum of the minimum termination value.

Challenger strongly supports the use of an illiquidity premium for the valuation of certain life insurance liabilities. It is essential that the method:

- is responsive to changes in market conditions;
- is set at an appropriate level; and
- results in a consistent treatment of assets and liabilities in a shock scenario.

Under accounting standards, life companies are required to mark their assets to fair value. Movements in the fair value of assets can be impacted by changes in the risk-free discount rate, credit risk premiums and illiquidity premium. An example of the importance of the illiquidity premium as a component of the fair value is the experience during the GFC where a large part of the blow out in spreads on debt securities was driven by illiquidity constraints rather than a deterioration in the outlook for credit. This means that any yield shocks to debt securities actually represent a combination of a shock to illiquidity premium and credit spread.

In order to ensure an appropriate matching of movements in assets and liabilities, the life company's liabilities should also change over time in line with market conditions. This must include movements in risk-free discounts rates and illiquidity premiums that are reflective of those market conditions: to apply a conservative approach to the determination of these factors will lead to an inappropriate mismatch between the valuation of assets and liabilities resulting in unnecessarily pro-cyclical outcomes. This requirement for an illiquidity premium which responds to changes in market conditions is greater in a regulatory environment where the base risk-free rate is the bond rate rather than the swap rate: the swap rate responds, albeit to an incomplete extent, to movements in the underlying price for liquidity.

We observe that ADIs generally value both assets and liabilities on an historic cost basis, including for the purposes of regulatory capital, providing symmetry in their valuations. As noted above, life companies are required to mark their assets to fair value, and therefore liabilities must be similarly marked in order to achieve a degree of this same symmetry[1]. Using an illiquidity premium that:

- is not responsive to changes in the market; or

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[1] An ADI's capital position will remain less volatile since, only in the event that the ADI determines that an asset is impaired, will the carrying value of the asset deviate from par. On the other hand, a life company's asset values will reflect the changing market assessment of credit outlook.

- is set at an inappropriately conservative level; or
- which does not change in the shock scenario;

will result in an inappropriate lack of symmetry between the movements in assets and liabilities. This will result in life companies being adversely impacted compared to the approach taken for ADIs, leading to:

- a lack of harmonisation of capital standards;
- a lack of competitive neutrality for products with similar characteristics;
- a significant impediment to the continued development of a viable, competitive and innovative life insurance industry; and
- excessively pro-cyclical prudential regulatory settings.

There are several methods by which an illiquidity premium can be estimated, and we note APRA's intentions set out in the 31 March 2011 paper "Response to Submissions – Review of capital standards for general insurers and life insurers" that the "amount of insurer/actuary discretion involved in determining the illiquidity premium should be small". To this end, Challenger supports the adoption of the method set out in the 17 November 2011 submission from the Actuaries Institute to APRA regarding illiquidity premiums (Actuaries Institute method, method). This method consists of:

- a formula for the calculation of an illiquidity premium;
- a term structure of illiquidity premium; and
- an approach under which, for the purposes of determining the PCA, the 'A' bond credit spread shock is applied to the formula and the resulting illiquidity term structure applied to the relevant liabilities. This serves to ensure consistency between the treatment of assets and liabilities in the shock scenario.

In considering the Actuaries Institute method, it should be noted that:

- the Actuaries Institute submission notes that the method is for use in regulatory prudential capital calculations, specifically for the calculation of the Prescribed Capital Amount of Pillar 1 of the proposed regulatory capital framework;
- the Actuaries Institute method provides a simple proxy based on readily available public information. It therefore satisfies APRA's requirement that the amount of insurer/actuary discretion should be small;
- the Actuaries Institute notes that the instruments which have been used to derive the method are generally more liquid than the life insurance policy values for which APRA intends to permit the application of an illiquidity premium. In our view, this means that the proposed formula already includes a level of inherent conservatism because it will tend to underestimate the illiquidity premium appropriate to life insurance liabilities;

- the curves which have been fit to the data produce high correlation results to the base data (96% and 91% respectively for the shorter and longer term formulae); and

- in constructing the term structure for the method, the Actuaries Institute used an approach whereby the illiquidity premium is level for a period of time and then reverts to a long term level. This is despite the fact that illiquidity premium should, in theory, be upward sloping with time, and reflects the possibility that a life company may not be able to capture the longer term illiquidity premium. As such, the term structure includes another level of conservatism.

As such, the Actuaries Institute method represents a market-based, robust and somewhat conservative approach to the determination of illiquidity premium, and we support its implementation. We submit that there is no justification for the Actuaries Institute method to be made more conservative through changes to parameters or caps, and indeed such adjustments would materially reduce the effectiveness of the formula.

2.2 Products to which Illiquidity Premium applies

The draft Prudential Standard LPS112 specifies that the illiquidity premium may only be added to the risk-free discount rate for policies that are:

(a) Immediate life annuities;
(b) Immediate term certain annuities;
(c) Fixed term / rate business; and
(d) Funeral bond business.

We submit that the word “immediate” should be deleted from both (a) and (b) above. That is, the illiquidity premium should also be added to the risk-free discount rate for deferred annuities.

There is a growing awareness of the longevity risk faced by retirees. Many commentators, professional organisations and corporates have called for the removal of impediments to the development of new products to address longevity risk, including deferred annuities. If the illiquidity premium cannot be used in the calculation of RFBEL for deferred annuities, this will serve as a further impediment to the development of this type of product.

2.3 Look through

The draft standards do not contemplate look through of investment entities. We understand from discussions with APRA that this was inadvertently removed from the draft standards and that it will be reinserted in the next drafts. We submit that look through of investment entities is appropriate as it results in the life company’s effective exposure to various risks being properly considered. We therefore support APRA’s intention to reinsert the wording.

We understand, however, that APRA intends to require look through of all investment entities. This is in contrast to the current standards where the Actuary is only required to look through unlisted or controlled investment entities that represent more than 1% of the value of the statutory fund.

We submit that such a limitation on look through should be maintained. Indeed, the materiality limit should be increased to 2.5% of the value of assets of the statutory fund, consistent with the increase in asset concentration limit for “other assets” under draft Prudential Standard LPS117.

This is on the basis that:

- requiring look through of all investment entities can result in unnecessary complexity where the holding is for a small proportion of the value of assets of the statutory fund; and

- in many cases, sufficient detail may not be available to allow appropriate look through. This is particularly the case for listed unit trusts, where information may be restricted due to policies aimed at stopping insider trading, or externally managed mandates.

In cases where investment entities are not looked through, they should be treated as equities, either listed or unlisted as appropriate, and treated as a single investment for the purposes of asset concentration risk.

2.4 Requirement to revalue residential mortgages every 3 years

The draft Prudential Standard LPS001 sets out that, in order to use the methodology set out in paragraph 7 of Attachment A to that standard, the valuation date of the property or other asset must be no more than 3 years old and the valuation must have been performed by a qualified valuer.

We submit that this requirement should be removed because:

- it is impractical. Such a requirement places significant additional external expense and administration costs on the life company. Further, it would create significant inconvenience for the borrowers from the life company; and

- it is not required for ADIs lending against residential properties.

This results in a significant disadvantage to life companies compared to ADIs in the provision of mortgages over residential property. This is contrary to the requirements of the *Australian Prudential Regulation Authority Act 1998* which requires APRA to consider competitive neutrality.

Further, that Act requires that APRA promotes financial system stability in Australia. Challenger has previously made significant submissions setting out that life companies investing in long term assets, such as residential mortgages, promotes financial system stability because life companies do not take part in liquidity transformation in the same manner as ADIs.

2.5 Requirement to revalue any secured property if material change in market

The draft Prudential Standard LPS001 sets out that a life company must revalue any property offered as security when it becomes aware of a material change in the market value of property in an area or region.

We submit that this requirement should be removed for similar reasons to those set out in 2.4 above. In addition:

- we assume that this is only in respect of adverse changes compared to the previous valuation. That is, we assume that APRA is not concerned where property in a region has undergone a material increase in value, nor where a material decrease in value occurs following a material increase, such that the property is still expected to be value at a sufficient level to support the loan; and
- such an approach adds even further impracticality because a large number of properties in a region would need to be revalued at the same time following a material reduction in values. It is reasonable to consider that, were such a requirement imposed on life companies and ADIs, a material reduction in market values in a particular region could lead to the majority of properties in the region needing to be revalued. This would obviously put significant stress on available resources to carry out such valuations as well as causing unnecessary costs, delays and unnecessary capital imposts as the valuations are undertaken.

2.6 Credit derivatives

The draft Prudential Standard LPS114 sets out that a life company must consult with APRA prior to entering into derivative contracts other than those over equities, interest rates and foreign exchange.

We submit that derivatives over credit should also be included in this list. That is a life company should be able to enter into credit derivatives without consulting APRA in advance.

Draft Prudential Standard LPS114 includes stresses to credit spreads and defaults, and requires life companies to consider the effective exposure of the fund's assets to these risks. The principles based approach of the standard therefore already provides an effective capital regime for credit derivatives.

2.7 Reductions in Capital Base

The draft Prudential Standard LPS110 sets out that if a company wishes to pay dividends on common shares, or dividends or interest payments on Additional Tier 1 or Tier 2 capital, that exceed a life company's after-tax earnings in the financial year (as defined) to which they relate, it must seek APRA's written consent.

Such an approach:

- is inconsistent with a principles-based framework and APRA's previous statements with respect to its intervention framework;
- leads to unnecessary delays arising from the requirement for the life company to provide an updated ICAAP report, along with any timeframes required for APRA to assess the application; and

- creates greater uncertainty for the providers of capital to life companies, as they may not be able to receive dividends and or capital returns even where the life company holds significant excess capital.

This may then have the unintended consequence of encouraging capital providers to hold minimum levels of capital in the life company, and lead to an increased cost of shareholder capital and lower returns to future customers.

We submit that the existing requirements are sufficient, being that a company must obtain written advice from the Actuary prior to any distributions from a statutory fund, and the restrictions on interest and capital returns on subordinated debt.

If APRA were to introduce such a requirement, then it should:

- not require an updated ICAAP report;

- specify the criteria that it will consider in determining whether to consent to a reduction in capital base; and

- commit to providing its consent in a timely manner, with defined service standards.

2.8 Use of Fair Values

The draft Prudential Standard LPS112 specifies that "where APRA considers that fair value are not prudent and reliable, APRA may, in writing, require a life company to make adjustments to the fair values of its assets and/or liabilities, or to hold higher levels of capital."

Life companies are required to mark assets backing policy liabilities to fair value. This is then subject to audit sign-off as well as sign-off from the Board.

We submit that APRA should not require a life company to make adjustments to the fair values of its assets and/or liabilities. This puts APRA in the position of over-riding the assessments of management, the Board and an independent audit in financial statements which are determined in accordance with accounting standards, rather than prudential standards.

Should APRA believe that the fair value of an asset or liability is not prudent or reliable, and such a situation results in prudential concerns, APRA has significant other powers, such as supervisory adjustments to capital requirements, to address its concerns.

2.9 Concentration Risk

The current standards contemplate asset concentration limits against which are tested the value of any single asset or single credit exposure. The draft Prudential Standard LPS117 extends this to include groups of related counterparties or related exposures. This means that an investment in Company A would get the same treatment in respect of concentration risk as an equivalent dollar investment split evenly across Company A and B where A and B are related. We submit that this outcome is inappropriate as it assumes that there is 100% contagion risk between related entities, even though the exposures are

to separate legal entities. The standards should continue to be applied in the same way as the current standards, that is, against single assets and single credit exposures.

2.10 Covered Bonds

Following recent changes to the *Banking Act 1959* to allow for the issuing of covered bonds by ADIs, this asset class needs to be considered in the context of the LAGIC asset risk charges. The draft Prudential Standard LPS114 sets out:

> *"A securitised/structured asset is an asset that provides an exposure to a pool or portfolio of assets or risks."*

Further, draft Prudential Standard LPS114 sets out:

> *"Credit wrapped bonds must be treated as a securitised asset if the external rating of the bond makes some allowance for the structural protection offered by the credit wrap."*

Covered bonds are secured against the assets of the reference pool in the event of default by the issuing ADI, and any shortfall is deemed to be an unsecured creditor of the ADI.

It is possible to interpret this to mean that covered bonds should be treated as securitised assets, despite their unequivocally superior credit worthiness relative to a senior unsecured bond issued by the same bank. APRA's Technical Paper Review of capital standards for general insurers and life insurers Asset risk capital charge sets out that the higher credit charge applied on securitised assets reflects "their complexity and the difficulties associated with rating and assessing their inherent risk". We submit that covered bonds issued by ADIs are not subject to these factors and should be treated as bonds for purposes of applying shocks to credit spreads, using the external rating of the issue, without adjustment.

2.11 Wholesale Business

The draft Prudential Standard LPS001 defines Wholesale Business to mean superannuation business where the effective purchasing decision is made by a trustee or company except where the number of members has always been less than five it is retail business.

We submit that the limitation of the definition to superannuation business is unnecessary, and ordinary business where the effective purchasing decision is made by a trustee or company should be considered wholesale business.

Attachment 2: Further issues requiring clarification

1. LPS001 - Definition of Insurance Contract

We suggest that the words "where the event is adverse to the interests of the policyholder" be removed. The words are unnecessary for the definition, and it could be argued that, for example, living longer (longevity risk) is not adverse to the interests (in their totality) of the policyholder. As an alternative, the definition could refer to "financial interests of the policyholder".

2. LPS001 - Definition of Statutory Accounts

Statutory Accounts are defined to mean the reporting documents that a life company is required to lodge with APRA under section 13 of the *Financial sector (Collection of Data) Act 2001*.

The LIASB, in its December 2005 Explanatory Statement on Revised Actuarial Standards to coincide with the implementation of International Financial Reporting Standards Prudential Implications, stated that:

> *"The Board considers that prudential standards should continue to be based on unconsolidated accounts."*

We note that the requirements around prudential reporting allow both the consolidated and unconsolidated approach, but also that the lodgment procedures require consistency between the capital forms and the balance sheet form. We suggest that APRA clarifies the approach it expects companies to adopt when reporting under the new standards.

3. LPS001 – Attachment A 1(b)

Attachment A section 1(b) states that "A secured or mortgaged asset comprises an investment held by way of a registered lien, charge or mortgage over residential property or an asset of a like kind." This wording is slightly different from the current Prudential Standard LPS7.02 which states that "A secured or mortgaged asset is an investment with collateral that is either an existing residential property or such other asset for which a substantive valuation has been obtained within the preceding 3 years."

We suggest that APRA clarifies what is meant by "of a like kind". Does it mean an asset that is encumbered, or does it mean that it must be a "of a like kind" to a residential property? We assume that the intention is to refer to assets that are secured in a similar manner to a mortgage on a residential property, irrespective of the type of asset.

4. LPS112 – Deductions from Common Equity Tier 1 capital

Section 25(i) sets out that assets that are under a fixed or floating charge or other security, to the extent of the indebtedness secured on those assets, should be deducted from Common Equity Tier 1 capital.

However, any indebtedness secured on assets will already be reflected in the balance sheet of the entity and therefore already be deducted from Common Equity Tier 1 capital.

We suggest 25(i) either:

- be removed; or
- include clarification that the deduction should be limited to any amount in excess of the liability that is recognised in the balance sheet.

5. LPS114 – Application of expected inflation stress

Section 38 states that "The stress adjustments must also be added to any explicit expected inflation rates used in the valuation of assets or liabilities."

Real assets such as property and infrastructure assets will often use valuation techniques that include growth of future rent and/or other income, which likely make use of explicit inflation assumptions.

We assume that it is not APRA's intention that the values of such assets should have an expected inflation stress applied to the valuation and then apply the equity and property stresses. We suggest that this be clarified.

Attachment 3: Summary of outstanding items from Challenger submissions dated 4 August 2011 and 3 November 2011

Our submissions of 4 August 2011 and 3 November 2011 set out a number of areas that needed to be addressed to ensure the new capital standards deliver the required outcomes. Some of these have since been addressed in the Response Paper and draft standards. We have addressed a number of the remaining issues within Attachment 1. We have set out below a summary of the issues where we believe the drafts standards still need refinement, and we refer you to our 4 August 2011 and 3 November 2011 submissions for more details in regards to each of the following:

i. Harmonisation with ADI capital requirements: The current capital standards result in a lack of alignment in capital requirements for products with similar risk profiles issued by different APRA-regulated institutions, and the proposed standards serve to make this misalignment worse. Specifically, term certain annuities issued by life insurers have the same risk profile as term deposits issued by ADIs, and yet the capital imposts on term certain annuities are materially higher than those of term deposits even where those liabilities are backed by the same assets.

ii. International comparability: The proposed standards are out of line with international developments, specifically Solvency II, and result in a significantly higher capital burden on Australian life insurers. This is detrimental to the interests of Australian consumers and places Australian life insurers at a significant disadvantage.

iii. Correlation Factor for Aggregation Benefit: We welcome the reduction of the correlation factor for the aggregation benefit to 20%. However we believe that there is no correlation between asset and insurance risks and that a correlation factor of 0% would be appropriate.

   The application of the proposed aggregation approach results in inappropriate outcomes for life insurers whose major insurance risk is longevity risk. The diversification allowance should be undertaken either by:

   - including longevity risk as a separate risk in the aggregation benefit calculation, with longevity risk being negatively correlated with insurance risk and having zero correlation with asset risk; or

   - replacing the three correlation matrices with a single matrix covering all risks, with longevity risk having a negative correlation with insurance risk and a zero correlation with asset risk.

iv. Disaggregation: It is appropriate that a property with a long term lease to a credit worthy counterparty should have a lower capital requirement than a vacant property. This is in accordance with APRA's stated goal of making the capital standards more risk sensitive.

   We submit that:

- the residual shock to the property sub asset (after remove the component related to the lease stream) should be based on the equity shock, as this results in a higher shock being applied to a then vacant property; and
- the combination of shocks in respect of the property, including the shocks to the lease sub asset, should be included in the property module for aggregation purposes.

In the alternative, if APRA retains the QIS2 proposed approach to disaggregation, we submit that the property rental streams should not be subject to a credit shock, because the entire property value has already been subject to the property yield shock. We note however that this is a significantly poorer approach than our primary submission.

v. Asset Risk Correlation Matrix: The proposed correlation between property values and credit spreads is too high, and should be around 30%.

vi. Free Assets and Asset shocks: Either:

- asset shocks should not be applied to free assets, as per the current standards; or
- asset shocks should be adjusted downwards to take account of the capital being applied to free assets.

vii. Operational Risk Calculation: We note and welcome the change to exclude reinvestments of maturing policies from the calculation of the material change factor for operational risk of non-risk business.

However we remain of the view that the factor to apply for annuity business should be materially lower than for investment-linked business as annuity products are not subject to the risk of unit pricing error. We therefore submit that a factor of 0.10% rather than 0.25% is appropriate.

viii. Overall adequacy: The proposed standards result in increased capital requirements that are overly onerous to the detriment of the life insurance industry, its policy owners and the public in general.

ix. Cost benefit analysis: The proposed cost-benefit approach is deficient, in that it does not consider the cost of capital associated with complying with new regulations nor the impact on returns payable to policy owners. In assessing the cost-benefit implications of the implementation of any new standards, APRA should demonstrate a positive cost-benefit to policy owners and prospective policy owners.